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We maintain a defensive tilt in our positioning. (Shutterstock)

Ask CIO – Stocks, China, and fixed income

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The S&P 500 has risen more than 10% from its October low, but the rebound stalled last week amid renewed concerns about the economic growth outlook. Are we likely to see a more sustained rally? In our latest "Ask CIO" segment, we look at this and other key questions for investors.

Is the equity rally sustainable?
The S&P 500 has climbed more than 10% since its mid-October low, despite a 3% pullback last week. Investor sentiment has oscillated between hopes of less aggressive Federal Reserve policy as inflation cools, and concerns about the cumulative impact of rate hikes on economic growth and corporate earnings in 2023.

We don't think the economic conditions are yet in place for a sustained upturn. With inflation still high, interest rate cuts remain a distant prospect, in our view. Past monetary tightening will likely lead to further economic weakness and a contraction of US earnings in 2023. As a result, we advise adding downside protection. We prefer the more defensive areas of the equity market—including healthcare, consumer staples, and quality-income stocks—which should be relatively resilient as economic growth slows.

Is China finally reopening?
Chinese equities (MSCI China) have risen more than 30% since the start of November following multiple positive reopening signals from Beijing. Vice-Premier Sun Chunlan has said that China's efforts to fight the COVID-19 virus are entering a new stage.

We expect a bumpy transition period ahead. In our base case, a full reopening—which we define as a permanent end to snap lockdowns—is most likely by early 3Q23. The latest developments are in line with our view that China is paving the way for such a scenario as it puts economic growth back in focus. For investors, we see select opportunities in sectors that should directly benefit from China's eventual reopening, including pharma and medical equipment, consumer, internet, transportation, capital goods, and materials.

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Should I lock in improved yields?

Government bonds have fallen in tandem with stocks in 2022. The yield on 10-year US Treasuries has climbed this year from 1.63% to 3.54% as of 12 December. Total returns have been broadly negative, from a 0.9% loss on US senior loans to a loss of 17.3% on Asian high yield bonds, as of 8 December.

But, while we expect further volatility ahead, we believe various opportunities have opened up in the fixed income space following this year's sell-off. In uncertain times, we see the opportunity to earn more predictable returns as especially appealing. We think the Fed will ultimately be successful in cooling inflation and will become less aggressive in tightening policy. In addition, higher yields are now on offer, making certain parts of the asset class look more attractive, in our view. We prefer higher-quality and investment grade bonds versus high yield.

For more Top 10 questions answered, see the UBS House View Briefcases.

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